

OSBD ISSUES

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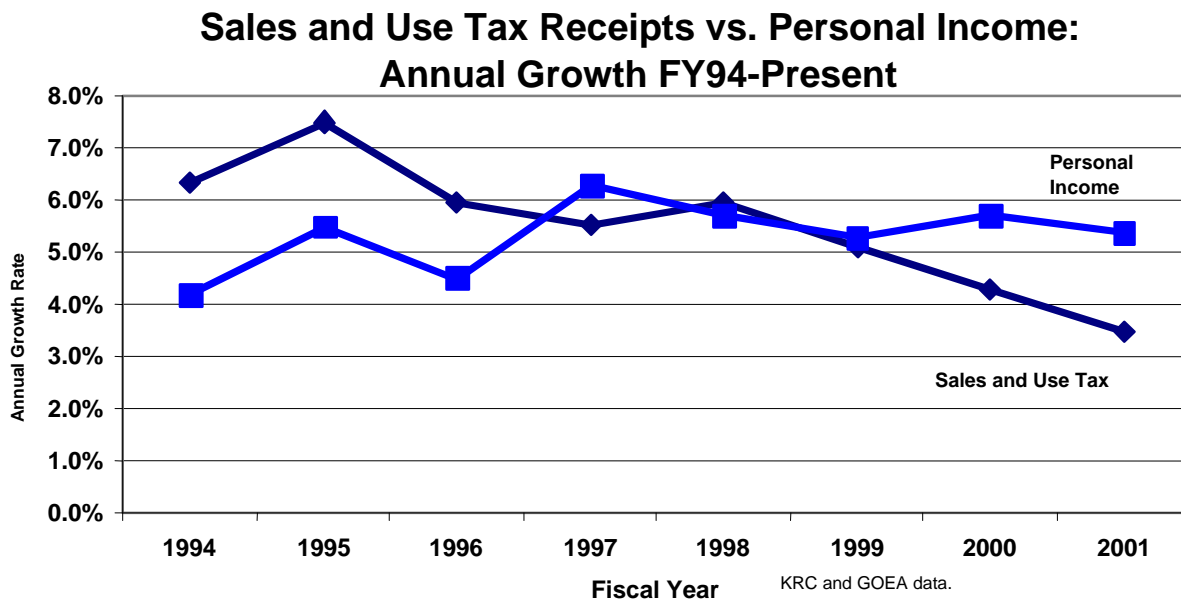
Kentucky Losing Ground on Sales Tax

The Issue

The sales tax base for Kentucky state government is shrinking because of the expanded use of services that are not subject to sales tax and various outdated legislatively-granted exemptions. The erosion is also due to the growth of remote sales including those made through the Internet, as well as changes in business sales-tax planning.*

Kentucky Sales and Use Tax

Kentucky has two principal sources of revenue: personal income tax, and the sales and use tax. Together, these two taxes make up over 75% of the General Fund revenue. Currently, Kentucky consumers and businesses pay a sales tax rate of 6% on items such as restaurant food, clothing, cigarettes, building materials and computers. At the time the sales tax was first instituted it was designed primarily to tax goods and not services.



Sales and use tax plays a critical role in stabilizing government finances because it is much less volatile than individual income tax. Over the past several years, there has been a consistent downward trend in the growth of sales tax as it relates to personal income (see chart above). The slowing economy is only one of several factors contributing to this decline. Other broad reasons for the erosion of the sales tax base include: a change in consumer buying pat-

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terns; growth in remote (Internet) sales; more sophisticated industry practices; and, legislative exemptions and court decisions. In order to maintain critical services for the citizens of the Commonwealth, a variety of solutions must be found in order to increase the rate of growth in sales and use tax revenue. Currently, Kentuckians pay a sales tax rate of 6% on a variety of items such as restaurant food, clothing, cigarettes, building materials and computers.

How Sales and Use Taxes Have Been Affected

The increased activity of remote (mail order and Internet) sellers in the Kentucky market is one of the factors affecting sales tax revenues. It has been estimated that 18% of Kentucky adults have made a purchase over the Internet. Although consumers are required to pay a use tax on items purchased through mail order catalogues or over the Internet, most do not. The sales and use tax comprises about 35% of the Commonwealth's total revenue collections making the loss to remote sales significant. Even more significant though is the fact that a substantial part of Internet commerce is the business-to-business component of electronic commerce. Kentucky's above average dependence on manufacturing makes it vulnerable to a greater impact than felt by other states as business-to-business e-commerce reduces the cost of acquiring equipment and supplies in this industry. It has been estimated that 46% of sales and use tax is on business-to-business transactions. Businesses are ordering more and more parts over the Internet, which reduces the ability of the Commonwealth to collect the tax. Recent estimates of the new e-commerce (Internet sales) loss in Kentucky range from \$84 million in 2001 to \$286 million in 2006*.

Changing demographics also have affected the revenue generated by the sales tax as consumption patterns have shifted from goods to non-taxable services. Kentucky's sales tax is not an overall consumption tax. In other words, it was imposed only on "tangible" personal property. Thus, most services like medical, cosmetic, legal and other personal services are not taxed. For example, as our population ages, the demand for medical and related services increases. There are also more women in the labor force that has resulted in the need for services catering to a two-income family, such as day care.

It is also not surprising that the responsiveness of the sales tax to income has diminished this period of rapidly expanding income and wealth. Much of the stock market wealth and a greater share of income growth has occurred in higher income brackets, precisely the households least likely to spend additional income on taxable goods. High income families spend more on services, save more, buy more on-line, and travel out-of-state more as a fraction of income than lower-income families. The result is that personal income grew without an equal rise in spending on taxable goods.

Another significant trend is the increasing emphasis of business sales tax planning. Tax professionals are concentrating more on sales and use tax at the same time that there has been a decrease in experienced staff which has led to greater challenges in administering sales tax law. Their tactics have included filing selective refund claims for business clients they claim have overpaid their tax. Tax professionals have also become more active in protesting audits and seeking settlement agreements for their clients. In a 1999 article, Richard Pomp** cites the increased attention given by corporate CEO's and CFO's to state tax matters as a source of corporate tax reductions. Tax practitioners have begun to develop new business practices to specifically avoid sales and use tax liability for their clients. For example, liability for the sale of retail business assets has been avoided through the creation of related party LLC's that hold the assets just prior to sale. When these assets are ultimately sold, the state does not collect sales

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tax. The expected outcome is that best practices in identifying when and on which items to pay use tax will spread throughout the taxpayer community. As a result, we should expect a decline in use tax receipts.

Kentucky has also provided various sales and use tax exemptions, many of which are now outdated, for certain industries and products. One example is the pollution control exemption passed in 1974 but which now has outlived its usefulness. The pollution control exemption was enacted to provide an economic incentive for manufacturers to invest in environmental controls they are now required by law to perform. In other words, we now offer tax breaks on environmental controls which no longer are voluntary. Elimination of this exemption could save the Commonwealth as much as \$13 million per year. Kentucky's tax code is also filled with other exemptions, the decisions about which were made in a very different economy than today's.

The Bottom Line

The New Economy of the 1990's is a service oriented economy; not an economy for which our goods-based sales and use tax was designed. Consumers buy more services and buy more from out-of-state without having to leave their homes. The income distribution widened, sending more dollars out of the traditional variety store tax avenues. Companies, having tamed the corporate income tax, aimed their tax attorneys at the more lucrative sales and use tax. Finally, decades-old exemptions continue to drain the state coffers without compensating income-generating incentive effects. The bottom line is that economics, demographics, avoidance and technology have weakened a once robust state tax base.

*Bruce, Donald, and William F. Fox, "State and Local Sales Tax Revenue Losses from E-Commerce: Updated Estimates," Center for Business and Economic Research, University of Tennessee, September 2001.

**Pomp, Richard, "The Future of the State Corporate Income Tax: Reflections (and Confessions) of a Tax Lawyer," *State Tax Notes*, March 23, 1999.

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